No. 78-561

In the Supreme Court of the United States

OCTOBER TERM, 1978

UNITED STATES OF AMERICA, PETITIONER

v.

NEIL T. NAFTALIN

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES

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CITATIONS

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a–11a) is reported at 579 F.2d 444. The opinion of the district court (Pet. App. 15a–20a) is not reported.

JURISDICTION

The judgment of the court of appeals (Pet. App. 12a–13a) was entered on June 13, 1978. A timely petition for rehearing was denied on August 4, 1978 (Pet. App. 14a). On August 31, 1978, Mr. Justice Blackmun extended the time for filing a petition for a writ of certiorari to and including October 3, 1978. The petition was filed on October 2, 1978, and was granted

on December 11, 1978. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether Section 17(a)(1) of the Securities Act of 1933 prohibits fraudulent practices that injure brokers who serve as intermediaries in the offer or sale of securities but who are not themselves investors.

STATUTORY PROVISIONS INVOLVED

1. Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1), provides in part:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud * * * [or]
>
> * * * * *
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
>
> * * * * *

2. Section 2(3) of the Securities Act of 1933, 15 U.S.C. 77b(3), provides in part:

> The term "sale" * * * shall include every contract of sale or disposition of a security or interest in a security, for value. The term * * * "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

STATEMENT

1. Respondent was the president of Naftalin & Co., Inc., a registered broker-dealer firm operating in Minneapolis, Minnesota. From 1966 to 1969 respondent engaged in a "short selling" scheme. Respondent studied the prices of selected securities and when, in his judgment, those prices had peaked and were entering into a period of decline, he placed large sell orders with other brokers. When placing such orders, respondent either stated or implied that he owned the shares to be sold, *i.e.*, that the sales were "long." In fact, however, all the sales were "short;" respondent did not own any of the securities that he purported to sell (Pet. App. 16a–18a). The success of respondent's scheme depended on the accuracy of his predictions that the market prices of the securities would decline before he was required to deliver them. Respondent planned to buy the securities at lower prices and to take as profit the difference between the price at which he sold and the price at which he covered (*id.* at 2a–5a).

Between July and August 1969 respondent placed eight sell orders for securities listed on the New York Stock Exchange.[1] Because respondent had "cash

[1] Respondent placed sell orders for 500 shares of American Research and Development Company stock and 1,000 shares of Burroughs Corporation stock with Paine, Webber, Jackson and Curtis; 1,000 shares of Burroughs Corporation stock with Piper,

accounts" with the five brokerage firms that accepted the orders (Pet. App. 16a–17a), he was not permitted to engage in short selling.[2] If the brokers had known that respondent was selling short, they either would not have accepted his orders or would have insisted on the creation of a general account with the margin deposit required by law (Tr. 81–82, 141, 209, 238, 288–289, 357). To conceal the fact that he was selling short, respondent either expressly stated or implied that his sales were long (Tr. 19, 21, 67–69, 120–123, 152–153, 237–243, 314, 353–360). With only one exception,[3] the brokers executed the sell orders on the New York Stock Exchange by making sales marked

Jaffray & Hopwood, Inc.; 1,000 shares of Control Data Corporation stock with Dain, Kalman and Quail, Inc.; 500 shares of American Research and Development Company stock with Merrill Lynch, Pierce, Fenner and Smith, Inc.; and 1,000 shares of Fairchild Camera and Instrument Corporation stock, 500 shares of American Research and Development Company stock, and 1,000 shares of Avon Products, Inc., stock with H. S. Kipnis & Co. (Pet. App. 18a–20a).

[2] Federal Reserve Board Regulation T (12 C.F.R. 220.8(d) and 220.4(c)(1)(ii)) requires a customer who wishes to sell "short" to open a general account and make a substantial margin deposit. In addition to restraining excessive use of credit in securities transactions (see Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. 78g), margin deposits protect brokers who execute short sales against failures by their customers to deliver securities sold short (Tr. 16, 79–81, 207–208, 289).

[3] One of the orders, involving the sale of 1,000 shares of Fairchild Camera and Instrument Corporation stock, was executed by H. S. Kipnis & Co. by purchasing the shares for its own account (Pet. App. 9a).

"long" (Tr. 21, 26, 121–122, 138–143, 150–151, 206–209, 240–241, 278–279, 314–316).[4]

Contrary to respondent's expectations, the market prices of the securities continued to rise (Tr. 538–542). Unable to make covering purchases in time to meet his delivery obligations, respondent presented various excuses to the brokers but assured them that he owned the securities and was merely encountering difficulty in obtaining possession of them (Tr. 34, 83–84, 120, 145–146, 189–190, 255–256, 272, 344, 561). By September 1969, however, respondent realized that he could not meet his obligations and called a meeting of the representatives of the brokerage firms. He informed them that he did not own the securities in question and suggested that they "buy in" the number of shares needed to cover the sales at their own expense (Tr. 148–149, 554–558).[5] Each broker bought sufficient securities to fulfill its commitment to purchasers, but this process caused substantial losses to

[4] Sell orders placed on a national securities exchange must be marked either "long" or "short." 17 C.F.R. 240.10a–1(c). A broker may not mark a sell order "long" unless it "is informed that the seller owns the security ordered to be sold and, as soon as is possible without undue inconvenience or expense, will deliver the security * * *." 17 C.F.R. 240.10a–1(d).

[5] If a broker executes a sell order marked long and the seller fails to deliver the securities when due, the broker normally must "buy in" substitute securities for the purchasers. See 17 C.F.R. 240.10a–2(a). See also II L. Loss, *Securities Regulation* 1229–1235 (1961 ed.). This "buy-in" procedure serves as a form of insurance for investors who purchase securities through brokers.

the brokers (Tr. 31, 87–88, 147, 190, 279, 283, 320–321, 347–351, 554).[6]

2. The district court concluded that respondent had employed a scheme or artifice to defraud in the sale of securities, in violation of Section 17(a)(1) of the Securities Act of 1933, 15 U.S.C. 77q(a)(1), and that he had acted willfully and knowingly (Pet. App. 15a–20a). The district court found that respondent had represented that he was long in each security, "either by direct statement to that effect or by using words and phrases in placing the sell order which would be understood in the trade as a representation that Naftalin & Co. was 'long' in the stock." The district court also found that the brokers with which respondent dealt would not have accepted respondent's orders if he had told them the truth (*id.* at 17a). Respondent was convicted on all eight counts of the indictment.[7]

The court of appeals reversed (Pet. App. 1a–11a). Although the court was "convinced" that there was "no merit" to respondent's assertion that the evidence was insufficient to establish "fraud" (*id.* at 5a), it concluded that Section 17(a)(1) is not violated by

[6] See *Naftalin & Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166, 1170–1172 (8th Cir. 1972), for more detailed description of respondent's scheme. In that opinion the Eighth Circuit concluded that respondent had engaged in "obvious and calculated wrongdoing" (469 F.2d at 1172), resulting in aggregate losses to brokerage firms of more than $1,285,000.

[7] The court sentenced respondent to concurrent terms of five years' imprisonment, explaining that respondent had engaged in a "massive" scheme to defraud the brokerage firms (Sentencing Tr. 7).

"the species of fraud practiced against the defrauded brokers who were not purchasers * * *" (*ibid.*). Reasoning that the sole purpose of Section 17(a)(1) is to "protect investors from fraudulent practices in the sale of securities" (*id.* at 6a–7a), the court concluded that "the government must prove some impact of the scheme on an investor" (*id.* at 8a). Because only brokers suffered direct financial injury from respondent's fraud, and the "third party purchasers to whom the brokers sold were not deceived or defrauded in any way" (*id.* at 6a), the court held that respondent's scheme did not violate the statute.[8]

SUMMARY OF ARGUMENT

Section 17(a)(1) of the Securities Act of 1933 prohibits "any" scheme to defraud in a securities offer or sale. Nothing in the language or legislative history of the statute indicates that the identity of the parties defrauded is material. Because "[n]othing

[8] The court of appeals also reversed respondent's conviction on Count VI of the indictment, even though that count involved fraud on a broker who traded for his own account as an investor (*id.* at 9a–10a). The court reasoned that "the indictment did not allege that [the defrauded broker] was a purchaser and * * * [respondent] could not be tried on charges that were not made" (*id.* at 10a). Judge Ross dissented from the court's disposition of Count VI (*id.* at 11a). Although we believe that the court's reversal of respondent's conviction under Count VI was incorrect even assuming that Section 17(a)(1) applies only to investor fraud (see *Hamling* v. *United States*, 418 U.S. 87, 117 (1974)), we have not raised that question for review. See Pet. 5 n.4. Of course, if this Court accepts our construction of Section 17(a)(1) the convictions on all eight counts should be reinstated.

on the face of the statute suggests a congressional intent to limit its coverage" (*United States* v. *Culbert*, 435 U.S. 371, 373 (1978)), the statute should not be restricted to frauds involving investor injury.

Investor protection was an essential purpose of the provision, but it was not the only purpose. The protection of business and the economy as a whole from the harmful effects of securities fraud also was important. As the Senate Committee Report pointed out, "[t]he purpose of this bill is to protect the investing public and honest business." S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933). Because Congress intended to protect business as well as investors under the Act, lack of injury to a specific investor is no ground for denying application of Section 17(a)(1) where fraud is proven.

At all events, respondent's scheme was aimed at investors, even though the investors' losses were shifted to brokers by the brokers' obligation to "buy in" securities. If the brokers had refused or been unable to honor their buy-in obligations, the losses here involved would have been suffered by the investors themselves.

Finally, it is evident that the absence of effective sanctions against fraud practiced on financial institutions such as brokers, investment advisers, transfer agents, and trust companies would result in decreased deterrence of fraud. Fraud poses a threat to the integrity of the national securities markets that are served by such institutions and thus affects investors. An increase in the number of frauds practiced on financial institutions would decrease their efficiency and increase their cost of doing business, resulting in higher expenses for investors served by such institutions. Thus, investors are harmed by fraudulent schemes practiced on the financial institutions that serve them.

ARGUMENT

FRAUDULENT MISREPRESENTATIONS MADE BY A PERSON IN THE OFFER OR SALE OF A SECURITY VIOLATE SECTION 17(a)(1) OF THE SECURITIES ACT OF 1933 WHETHER OR NOT AN INVESTOR IS INJURED DIRECTLY

The decision of the court of appeals, which limits the coverage of Section 17(a)(1) to fraudulent practices that cause injury to "investors," effectively bars application of the statute to prohibit frauds practiced on financial intermediaries such as brokers, transfer agents, clearing agencies, and investment advisers. But the statute explicitly prohibits "any" fraudulent practice "in the offer or sale of any securities." That broad prohibition extends to the species of fraud practiced by respondent. Respondent's fraudulent scheme occurred at the very heart of the securities markets, causing injury to securities professionals whose services are essential to the process of trading. In the absence of legislative history showing that the statute should not be applied at face value, or that institutional intermediaries in the securities markets should be denied protection, there is no warrant for curtailing its coverage. As we dem-

onstrate below, Congress intended the broad language that it employed in Section 17(a)(1) to be taken literally.

A. SECTION 17(a)(1) UNAMBIGUOUSLY PROHIBITS FRAUD OF ANY KIND IN THE OFFER OR SALE OF SECURITIES

1. The language of the statute applies to respondent's fraud

" 'The starting point in every case involving construction of a statute is the language itself.' " *Teamsters* v. *Daniel*, No. 77-753 (Jan. 16, 1979), slip op. 6; *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 197 (1976); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J., concurring). Section 17(a)(1) of the Act prohibits "any person in the offer or sale of any securities * * * directly or indirectly * * * to employ any device, scheme, or artifice to defraud." The definitional section of the statute (Section 2(3), 15 U.S.C. 77b(3)), in turn, defines the terms "sale" and "offer" in the broadest possible manner:

> The term "sale" * * * shall include every contract of sale or disposition of a security or interest in a security, for value. The term * * * "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value.

The breadth of the term "sale" is shown by the provision that "contracts" to sell or dispose of securities are "sales." See *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 467 & n.8 (1969); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627, 634 (2d Cir.), cert. denied,

389 U.S. 970 (1967); *Roe* v. *United States*, 316 F.2d 617, 620 (5th Cir. 1963). The term "offer" is broader still, extending to "every attempt" to dispose of a security. See I L. Loss, *Securities Regulation* 512 & n. 163 (1961 ed.) ("[T]he definition of 'offer' is obviously much broader than the common law concept").

The statute proscribes fraud by "any person," without regard to his role in the securities transaction. The statute does not state or even suggest that the proscription depends on the identity or role of the victim of the fraud. Nor, finally, is there a limitation on the method used to commit the wrong, since the prohibition extends to "any" scheme to defraud, whether it operates "directly" or "indirectly." It is hard to imagine how Congress could have written a more sweeping statute. So long as jurisdictional means are used, Section 17(a)(1) prohibits, without limitation, all fraudulent schemes practiced by anyone against anyone in an offer or sale of securities. The rule is simple to understand: there are no exceptions.[9]

Respondent both offered and sold securities. Respondent placed sell orders with various brokers; the brokers executed the orders, resulting in contracts of sale within the statutory definition. Respondent also made "attempts" to "dispose of" securities, and thus made "offers" within the meaning of the statute, when he directed the brokers to initiate sale transactions. Respondent's fraud took place "in" these offers and

[9] Section 17(c), 15 U.S.C. 77q(c), specifically provides that the exemptions in Section 3 of the Act, 15 U.S.C. 77c, are inapplicable to Section 17.

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sales.[10] The fraud set the transactions in motion and was the basis for the transactions. Respondent deceived the brokers about the subject matter of the sales that they executed, and the brokers were injured as a direct consequence of that deception. Moreover, even though the brokers were not intended to be the "purchasers" of the securities in question, they had a direct financial stake in them. The brokers' "buy in" obligation (see note 5, *supra*) required them to insure the delivery of the securities. The brokers thus inevitably took part of the risk of the selling process, and here respondent's fraud caused real loss. Section 17(a)(1) thus applies to respondent's fraud.

Here, as in *United States* v. *Culbert,* 435 U.S. 371, 373 (1978), "[n]othing on the face of the statute suggests a congressional intent to limit its coverage." Just as it was improper to restrict the scope of the Hobbs Act "by reference to an undefined category of conduct termed 'racketeering'" (*id.* at 380), so it was improper for the court of appeals to restrict the scope of Section 17(a)(1) to "the species of fraud" practiced on "investors" (Pet. App. 5a). Here, as in *Culbert,* the broad words of the statute "do not lend themselves to restrictive interpretation" (435 U.S. at 373). Section 17(a)(1) covers "any" fraud in the offer and sale process, not just "the species of fraud" that injures investors. See *United States* v. *Gilliland,* 312 U.S. 86, 93 (1941).

[10] But for respondent's fraud, the sales would not have taken place. As the district court found, the brokers would not have executed respondent's orders if they had been told the truth about his "short" position (Pet. App. 17a).

Because the statute is unambiguously applicable to respondent's scheme,[11] there is no reason to apply rules of construction, such as the "rule of lenity" (see Pet. App. 8a–9a), that are designed to resolve ambiguity. As this Court observed in *United States* v. *Culbert, supra,* 435 U.S. at 379 "[i]t is true that 'ambiguity concerning the ambit of criminal statutes should be resolved in favor of lenity.' * * * But here Congress has conveyed its purpose clearly, and we decline to manufacture ambiguity where none exists." See also *Scarborough* v. *United States,* 431 U.S. 563, 577 (1977); *Barrett* v. *United States,* 423 U.S. 212, 217, 218 (1976); *SEC* v. *C. M. Joiner Leasing Corp.,* 320 U.S. 344, 354–355 (1943).

2. A comparison with other securities statutes establishes the scope of Section 17(a)(1)

Our contention that Section 17(a)(1) applies to "any" fraud in the offer or sale of securities, and not just "the species of fraud" practiced on investors, is fortified by comparing Section 17(a)(1) with the other anti-fraud provisions of the Securities Act of 1933. Congress understood the difference between general anti-fraud provisions and more limited

[11] Respondent can hardly claim that the statute provided inadequate notice. As both courts below concluded, respondent's short selling scheme was a calculated fraud. Moreover, the decisions of this Court had established, long before respondent undertook his scheme to defraud, that the securities laws were to be interpreted broadly to effectuate their remedial purposes. See, *e.g., SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 195 (1963).

ones dealing with fraud practiced on securities purchasers. The 1933 Act contains both kinds of rules. See *Blue Chip Stamps* v. *Manor Drug Stores, supra,* 421 U.S. at 734; cf. *Barrett* v. *United States, supra,* 423 U.S. at 217. For example, Section 17(a)(3) of the Act, 15 U.S.C. 77q(a)(3), prohibits fraudulent practices that operate "as a fraud or deceit upon the purchaser." Cf. Sections 11 and 12 of the Act, 15 U.S.C. 77k and 77*l*, which authorize the filing of civil damages actions by defrauded investors only. Section 17(a)(1), in contrast, is a "general proscription against fraudulent and deceptive practices" (*SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 197–198 (1963)), which places no limitation on the class of defrauded parties.

Of course, respondent's fraudulent scheme may have violated provisions of the federal securities laws in addition to Section 17(a)(1). It is likely that respondent's scheme also violated Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), which this Court has described as "parallel" to Section 17(a). *Blue Chip Stamps* v. *Manor Drug Stores, supra,* 421 U.S. at 733. Section 10(b) prohibits any person to employ any manipulative or deceptive device or contrivance "in connection with the purchase or sale of any security," in contravention of the Securities and Exchange Commission's rules and regulations. Respondent violated Section 10(b) because he employed fraud in connection with the placement of sell orders, which resulted in the execution of con-

tracts that are tantamount to sales (see pages 11–12, *infra*). But the applicability of Section 10(b) does not render Section 17(a)(1) inapplicable.[12] See generally, *Edwards* v. *United States,* 312 U.S. 473, 483–484 (1941); *SEC* v. *National Securities Inc, supra,* 393 U.S. at 468. Indeed, in one important respect, Section 17(a)(1) is broader than Section 10(b) and relates more precisely to the fraudulent scheme involved in the present case. "The wording of § 10(b) directed at fraud 'in connection with the purchase or sale' of securities stands in contrast with the parallel antifraud provision of the 1933 Act, § 17(a) * * * reaching fraud 'in the offer or sale' of securities." *Blue Chip Stamps* v. *Manor Drug Stores, supra,* 421 U.S. at 733–734. Thus, in order to reach fraud in respondent's "offer" of securities, as well as fraud in the "sale" of securities, the prosecution appropriately relied on Section 17(a)(1) rather than Section 10(b).[13]

[12] The fact that Section 10(b) applies to frauds that are "in connection with" a purchase or sale, while Section 17(a) applies to frauds that are "in" a sale or offer, is not significant here. Respondent's fraud was integral to the process of offering and selling securities. It was "in," not external to, that process. Moreover, although the expression "in connection with" may suggest a somewhat looser relationship to the securities trading process than the term "in," that difference should not be overstated. This Court has used the two expressions interchangeably. See *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971). So did Congress when Section 17(a) was enacted. See H.R. Rep. No. 85, 73d Cong., 1st Sess. 6 (1933); H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933).

[13] The indictment charged respondent with fraud in the "offer and sale" of securities (A. 15–21).

In sum, both the language of the statute, which prohibits "any" fraud in the offer or sale of a security, and its place in the statutory scheme, demonstrate the court of appeals' error. As we now discuss, moreover, the legislative history underscores the breadth of the statute.

B. CONGRESS INTENDED TO PROHIBIT ALL FRAUDULENT PRACTICES IN SECURITIES OFFERS OR SALES IN ORDER TO PROTECT BUSINESS AND THE NATIONAL ECONOMY AS WELL AS INVESTORS

The Eighth Circuit's limitation of Section 17(a)(1) to frauds injuring "investors" is not supported by the legislative history of the Securities Act of 1933. To be sure, Congress was deeply concerned with investor protection. Its prohibition of fraudulent practices had broader purposes, however. The 1933 Act grew out of Congress' conclusion that securities frauds were injurious to business and the general economy as a whole.

1. The Securities Act of 1933 was part of Congress' response to the stock market crash of 1929. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 194–195 (1976).[14] In addition to requiring full disclosure of information concerning public offerings of securities for the protection of investors, the Act was intended "to promote ethical standards of honesty and fair dealing." *Id.* at 195. A principal purpose of the 1933 Act, like

[14] The history of the Act is recounted in I Loss, *Securities Regulation, supra,* at 119–128. For the personal account of one of its draftsmen, see Landis, *The Legislative History of the Securities Act of 1933,* 28 Geo. Wash. L. Rev. 29 (1959).

the other federal securities laws, was to assure that "the highest ethical standards prevail in every facet of the securities industry." *SEC* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 186–187. See also *United Housing Foundation, Inc.* v. *Forman,* 421 U.S. 837, 849 (1975).

Congress' intent to enact a comprehensive anti-fraud provision is evident throughout its deliberations on the Securities Act of 1933. Cf. *SEC* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 191. Section 17, the general anti-fraud provision, began as Section 13 of S. 875, 73d Cong., 1st Sess. (1933), and H.R. 4314, 73d Cong., 1st Sess. (1933), parallel bills introduced in the House and the Senate. In relevant part, Section 13 provided that

> * * * it shall be unlawful for any person, firm, corporation, or other entity in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities defined by this Act willfully to employ any device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation or promise, or to engage in any transaction, practice, or course of business relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser. * * *

As redrafted by Professors Frankfurter and Landis, and resubmitted in the House of Representatives (see Landis, *The Legislative History of The Securities Act*

of 1933, 28 Geo. Wash. L. Rev. 29, 31–41 (1959)), the general anti-fraud provision read as follows:

> It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of, or omission to state, a material fact, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud upon the purchaser.

See H.R. 5480, 73d Cong., 1st Sess. Section 16(a) (1933). Among other changes made before passage of the bill, Congress expanded the antifraud provision to include all fraudulent schemes, whether practiced "directly or indirectly." See H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 12 (1933).

The comprehensive language of Section 17(a)(1), as finally enacted, which forbids "any device, scheme, or artifice to defraud," was apparently based on the general mail fraud statute, 25 Stat. 873 (now codified in 18 U.S.C. 1341), which forbids any person using the mails "to devise any scheme or artifice to defraud." See 1A. Bromberg, *Securities Law Fraud—SEC Rule 10b-5* 21 (1975 ed.); III Loss, Securities *Regulation, supra,* at 1421–1423. The sponsors of the bill made it clear, however, that Section 17(a) was in-

tended to expand existing law and to prohibit all forms of fraud in securities transactions. See, *e.g.,* remarks of Senator Fletcher, 77 Cong. Rec. 2983, 2984 (1933): "We are trying to cover instances where there seem to be loopholes and means of escape, and to apply the measure particularly to the matter of dealing in securities * * * The bill rather strengthens and broadens the authority to proceed in such instances." See also Douglas and Bates, *The Federal Securities Act of 1933,* 43 Yale L. J. 171, 181–182 (1933); III Loss, *Securities Regulation, supra,* at 1423–1424, 1428–1430, 1439; H.R. Rep. No. 1542, 83d Cong., 2d Sess. 26 (1954).

In emphasizing the need to eliminate fraudulent practices, the sponsors of the legislation referred repeatedly to business injuries resulting from securities fraud. See, *e.g.,* remarks of Senator Fletcher, 77 Cong. Rec. 2983 (1933); remarks of Senator Norbeck, *id.* at 3232 ("We all hope for an early business recovery, but that is impossible without a return to plain, old-fashioned business honesty"); remarks of Rep. Kelly, *id.* at 2925 ("I am for this securities bill * * * it will give protection to honest and legitimate industry which has been, in many instances, made the victim of greedy and ruthless investment bankers"); remarks of Rep. Chapman, *id.* at 2935 ("This legislation is designed to protect not only the investing public but at the same time to protect honest corporate business. * * * It will stimulate industry; it will accelerate the wheels of commerce"); remarks of Rep. Keller, *id.* at 2944, 2945 ("When the downright dis-

honesty * * * and conspiracy to cheat and defraud * * * are for a certainty done away with, we shall find the very conditions which business security demands * * *. These racketeers have broken down the capitalistic system * * * practically wrecked business * * *"). There is no suggestion in the legislative debates that Congress intended to protect investors but not financial intermediaries. To the contrary, investor protection and the security of the market process were seen as parts of the same goal.

The Senate committee report on the bill that ultimately became the Securities Act of 1933 stated clearly that "[t]he purpose of this bill is to protect the investing public and honest business." S. Rep. No. 47, 73d Cong. 1st Sess. 1 (1933). Business had been injured in various ways by dishonest securities transactions. Businesses seeking to attract capital through honest disclosures could not compete with other businesses employing misleading representations. *Ibid.* "Equally significant" as the loss suffered by individual investors was the "wastage that * * * irresponsible selling of securities * * * caused to industry." H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933). The House Report also pointed out, in its catalogue of abuses to be remedied, that "[e]ven dealers through the exertion of high-pressure tactics" had been "forced to take allotments of securities of an essentially unsound character." *Id.* at 3. See also S. Rep. No. 1036, 83d Cong., 2d Sess. 4 (1954).

In sum, Congress believed that proscription of all types of fraud in securities transactions would protect

would not be appropriate to limit

business and the general economy in addition to protecting investors. In light of these broad purposes, it Section 17(a)(1) to frauds causing injury to investors. The expansive language of Section 17(a)(1) was not inadvertent. It was prompted by an equally expansive remedial purpose. See *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 151 (1972); *SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 195.

2. The cases cited by the Eighth Circuit do not support its conclusion that the sole objective of the Act was investor protection. The only decision of this Court that the Eighth Circuit cites is *Ernst & Ernst* v. *Hochfelder, supra* (see Pet. App. 7a). But *Ernst & Ernst* points out that, in addition to protecting investors, Congress intended to "promote ethical standards of honesty and fair dealing." 425 U.S. at 195. The lower court decisions cited by the Eighth Circuit (Pet. App. 7a) merely state the obvious: that investor protection was a purpose of the Act. They do not suggest that the only purpose was to protect investors.[15]

[15] The case cited by the Eighth Circuit to establish that "the government must show some impact of the scheme on the investor" (*United States* v. *Ashdown*, 509 F. 2d 793, 799 (5th Cir. 1975)), does not stand for such a proposition. *Ashdown* affirmed a criminal conviction under Section 17(a), rejecting the defendant's contention that the government must prove "reliance" by investors on the misrepresentations. In discussing the jurisdictional requirement of the statute, *Ashdown* stated in dictum that the government must show use of the mails having some effect on an investor. The discussion in *Ashdown* dealt only with the question whether the use of the mails there involved was sufficiently important to the fraudulent scheme to satisfy the jurisdictional means requirement, an issue not presented here.

The lower court authority contrary to the Eighth Circuit's interpretation is substantial. *United States* v. *Brown,* 555 F.2d 336 (2d Cir. 1977), sustained a conviction under Section 17(a) where the defendant had defrauded a transfer agent [18] by submitting counterfeit stock certificates and obtaining genuine certificates in exchange. The Second Circuit squarely rejected the "investor injury" limitation adopted by the court below (555 F.2d at 338–339):

> While this court has noted that the primary purpose of the 1933 Act was to protect investors * * * appellant has not cited and we have not found any case holding that this was its sole purpose and that unless the ultimate purchaser of securities is injured or defrauded the criminal provisions of [Section 17(a)] are not violated. The language of that section * * * broadly condemns the employment of 'any device, scheme, or artifice to defraud' * * *. [T]here is no doubt that Congress in the broad language employed in [Section 17(a)] was intent upon protecting the integrity of the marketplace in which securities are traded.

Accord, *United States* v. *Gentile,* 530 F.2d 461, 467 (2d Cir.), cert. denied, 426 U.S. 936 (1976). See also *A.T. Brod & Co.* v. *Perlow,* 375 F.2d 393, 396–397 (2d Cir. 1967), holding that fraudulent practices

[18] A transfer agent registers the transfer of securities on behalf of an issuer and exchanges or converts existing securities. See Section 3(a)(25) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(25).

injuring brokers violate Section 10(b) of the 1934 Act and pointing out that Section 10(b) (like Section 17(a)) does not "speak[] in terms of limiting the nature of the violation to one involving fraud of 'investors.' "

C. PROTECTION OF FINANCIAL INTERMEDIARIES CONTRIBUTES TO INVESTOR PROTECTION

Although, as we have shown above, investor protection is not the only purpose of the Securities Act of 1933, it certainly is an important purpose. Consequently, although the lack of direct injury to an investor cannot provide a basis for refusing to apply Section 17(a)(1), the presence of such injury in this case would be an additional reason for applying Section 17(a)(1). As we demonstrate below, the protection of financial intermediaries contributes to the goal of investor protection.

1. Respondent's scheme was aimed at investors to the same extent that it was aimed at brokers. Respondent misrepresented his short position to brokers, and through them to investors, when he caused orders marked "long" to be executed on the New York Stock Exchange. Respondent caused brokers to sell phantom shares to real investors. The shares could not be delivered. Brokers suffered the direct loss here only because federal regulations required the brokers to "buy in" shares to deliver to the purchasers, thus covering for the delivery obligation that respondent fraudulently assumed. The "buy in" rule transferred the loss from the investors (who otherwise would have been deprived of the ownership of the appreciated

shares) to the brokers, who had to buy shares at the appreciated price and deliver them at the contracted for, lower price. This served as a form of insurance for the investors. If the brokers had been financially unable to buy in the shares, the investors themselves would have suffered the loss. Entitled to receive shares at one price under the purchase contract, they would have been forced to buy substitute shares in the market at a higher price.[17]

It is not logical to conclude that the "species of fraud" practiced by respondent was not harmful to investors simply because the investors happened to be protected by the brokers' "buy in" obligation.[18] As the Second Circut pointed out in *United States* v. *Brown*, *supra*, 555 F.2d at 339, "[o]ne might as well argue that if Brown stole [some person's] fully insured automobile, he was never the victim of a larceny." The court continued (*ibid.*):

[17] At the time of respondent's fraudulent scheme, there were certain exceptions to the "buy-in" duty based on the good faith and diligence of the brokers. See 17 C.F.R. 240.10a-2(b); Rule 440B of the New York Stock Exchange, 2 CCH New York Stock Exchange Guide ¶2440B.17-19. The brokers in this case were not entitled to relief under these rules.

[18] Section 17(a)(1) prohibits the scheme to defraud itself. The fact that the scheme may fail to harm an intended victim—perhaps because of the victim's diligence—would be no defense. "[I]t is clear that the establishment of a 'scheme * * * to defraud' under Clause (1) is not dependent upon proof that any victim suffered actual loss." III Loss, *Securities Regulation*, *supra*, at 1439-1440 (collecting cases). See *Farrell* v. *United States*, 321 F.2d 409, 419 (9th Cir. 1963) (it is "well settled" in the lower courts "that in a prosecution [under Section 17(a)(1)] the government is not required to prove that anyone was defrauded or that any investor sustained loss"). See also *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 195.

> The fact that the Uniform Commercial Code might ultimately shift the monetary loss from Smith and the ultimate investors hardly serves to exculpate Brown and his group of fellow thieves, counterfeiters and forgers from criminal responsibility. This was not of course the garden variety of security fraud—its long planned execution * * * constituted a massive assault upon innocent investors and brokerage houses and their normal business procedures which we cannot construe the statute to countenance.

What is more, when the 1933 Act was passed there was not yet a "buy in" requirement under federal regulations. At that time the loss caused by the "species" of fraud practiced by respondent could have fallen directly on purchasers. It is unlikely that the promulgation of the "buy in" requirement some years after the enactment of the 1933 Act could restrict the scope of Section 17.

2. The lack of sanctions against fraudulent schemes practiced on financial institutions harms investors in other ways. Losses suffered by brokers increase their cost of doing business; in the long run, investors must cover at least part of this cost by paying higher prices for brokerage and other services. There are many such financial institutions: broker-dealers,[19] transfer agents and clearing agencies,[20] investment

[19] Six thousand two hundred seventy-seven broker-dealers were registered with the Commission as of December, 1978.

[20] Eighteen hundred seventy-four transfer agents were registered with the Commission as of December, 1978.

advisers,[21] and commercial bank trust departments. The services performed by these institutions are central to the operation of the national securities markets and essential to investors welfare.[22] See *United States* v. *Brown, supra,* 555 F.2d at 339. In the end, fraud renders all of these services more costly or more risky, to the detriment of all investors.

It is significant, too, that fraudulent short selling schemes can disrupt the national securities markets, causing effects detrimental to all investors. Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. 78 g,, directs the Federal Reserve Board to adopt margin requirements for the purpose of preventing excessive speculation in securities purchases and sales. The Board has promulgated regulations that limit speculation by requiring short sellers to make substantial cash deposits. See note 2, *supra.*[23] Section 10 (a) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(a), authorizes the Securities and Exchange Commission to adopt rules governing short selling. The Commission has promulgated regulations (17 C.F.R. 240.10a-1) that limit short selling in declining mar-

[21] Five thousand three hundred eighty-five investment advisers were registered with the Commission as of December, 1978.

[22] Brokers, transfer agents, clearing agencies, and investment advisers are subject to pervasive regulation under the federal securities laws. See 15 U.S.C. 78*o et seq.*, 15 U.S.C. 78q-1 *et seq.*, and 15 U.S.C. 80b-1 *et seq.* Congress has not demonstrated an intent to impose the burdens of the securities laws on these financial institutions without conferring the protections of the securities laws.

[23] See also II Loss, *Securities Regulation, supra,* at 1239-1256; SEC *Report of Special Study of Securities Markets,* H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4, 9 (1963).

kets. By concealing the fact that he was selling short, respondent evaded both the requirement that he make a cash deposit and the requirement that he sell short only during appropriate market conditions. As the Eighth Circuit observed in its earlier opinion in *Naftalin & Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, supra,* 469 F.2d at 1181, "the artificial stimulation of the market resulting from Naftalin's short-selling scheme [is] in direct conflict with Section 7's objectives." See also *United States* v. *Peltz,* 433 F.2d 48, 53 (2d Cir. 1970): "Short selling without compliance with the margin and short sale price rules can have a materially larger adverse effect on the public than a seller's hoodwinking a buyer into an unfortunate purchase of a few hundred shares." Accord, *A. T. Brod & Co.* v. *Perlow, supra,* 375 F.2d at 397; SEC Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2, 292-293 (1963); II Loss, *Securities Regulation, supra,* at 1229 (" 'in a declining market certain types of short sales are seriously destructive of stability.' ").

Respondent's scheme to engage in substantial short selling transactions, escaping (by fraud) the restrictions prescribed by Congress, the Federal Reserve Board, and the Securities and Exchange Commission to protect the integrity of the national securities markets, thus posed a threat to those markets and to the investors participating in them. Even though investor injury is not prerequisite to a finding of liability under Section 17(a)(1), there was harm to the investing public here. That injury is an additional ground for applying Section 17(a)(1) to respondent's scheme.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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